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Fed Notes

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Next steps: CP, QE and beyond

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- Less than a week ago, the Fed slashed rates by 100 basis points to the effective lower bound, reintroduced a $700bn QE program, rolled out crisis-era purchase programs, and renewed global dollar swap lines. Despite these actions, US financial conditions remain historically tight, with our FCI falling to the lowest levels since the crisis. Tight financial conditions are the by-product of impaired transmission channels from monetary policy to the conditions that impact the real economy: real rates have risen sharply, the dollar has surged, and spreads for commercial paper, corporate and municipal bonds, and mortgages have widened sharply.
- Some of the above conditions have proved self reinforcing. For example, the rise in real yields, particularly at the long end, has been associated with a sharp rise in the trade-weighted dollar, which in turn has put pressure on commodity prices, breakeven inflation rates and, by extension, risk assets.
- In this note we discuss the next steps for Fed policy as it relates to commercial paper, the balance sheet and the prospects for expanding the Fed's authority to purchase corporate and municipal debt. The Fed has thus far shown an exceptional sense of urgency and flexibility in responding to this unprecedented shock. It is unlikely that revisions to – or expansions of – existing or past programs will be sufficient to promote accommodative financial conditions. As such, we should not discount the possibility that the Fed will receive authority to significantly expand the scope of what they can purchase.

Next step for commercial paper: Easing the terms

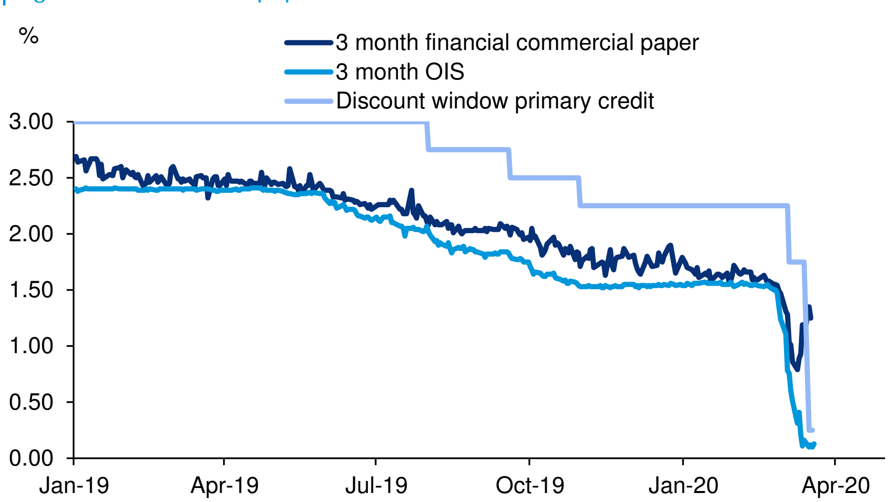
The Fed's immediate focus will likely be smoothing the flow of credit to businesses by unclogging the commercial paper market. This week the Fed resurrected two crisis-era liquidity facilities, the commercial paper funding facility (CPFF) and the money market mutual fund liquidity facility (MMLF). While these facilities should help enhance liquidity in the commercial paper market, it might take time for them to completely remove the market strains.

One of the problems plaguing the market currently is that prime money market funds which had faced large and unexpected redemptions over the past week had to sell a significant portion of their commercial paper holdings. The forced liquidations led to banks and broker dealers owning commercial paper at distressed yield levels. However, because the purchases took place before the MMLF announcement, those paper are not eligible as collateral at the MMLF. As a result, banks may have limited appetite to buy more from prime money market funds until the older paper mature and roll off their balance sheets.

There is also some critique that the pricing for the CPFF is too punitive. Through this facility, the Fed will purchase 3-month commercial paper directly from issuers at the 3-month OIS rate plus 200bp. However, similar maturity commercial paper are currently trading in the market at lower yields, which suggests that issuers may not need to engage the CPFF until market pricing converges to the CPFF.

The Fed can ease liquidity conditions further by loosening some of the terms for its commercial paper facilities. For example, it can expand eligible collateral for the MMLF to include assets previously purchased from prime money market funds. It can also reduce the pricing for the CPFF to be more in line with the market. The pushback for doing so could be that the Fed is inserting itself too much in the short-term credit market, which is traditionally an area the Fed has avoided intervening too closely. But to ensure that their accommodation is being transmitted to the economy, this may be a necessary step.

Figure 1: Commercial paper rates have failed to fall as the Fed has eased

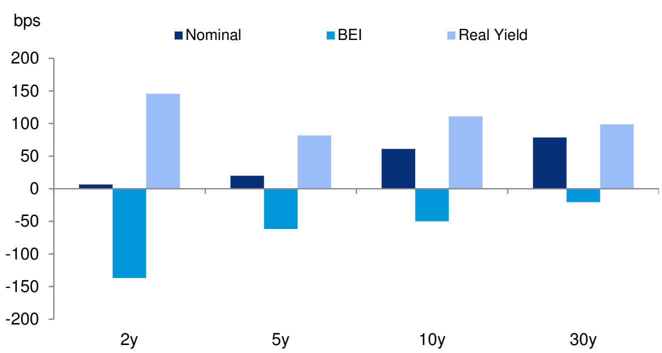


Source : FRB, REFINITIV, Haver Analytics, Deutsche Bank

Next step for the balance sheet: Re-up QE before considering front-end YCC

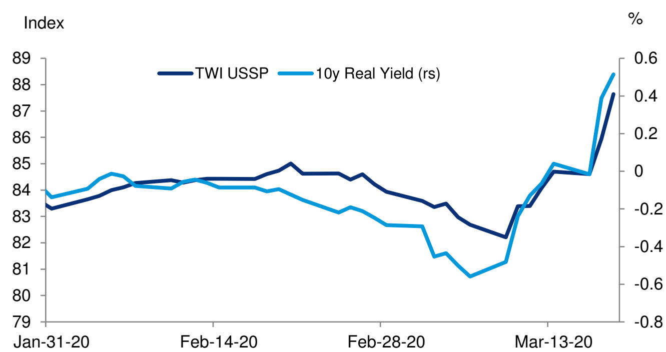
Since the Fed's aggressive actions to ease monetary conditions, nominal interest rates have not moved lower, and in fact recently rose to their highest level in several weeks, even as equities plunged. The dynamics of this yield rise have been troubling. Since the trough in nominal yields on March 9th, 2020, real yields have risen sharply across the curve, as the rise in nominals has been accompanied by a decline in breakeven inflation which was especially acute at the front end given the plunge in oil prices (Figure 2). At about 75bps, 10-year breakeven inflation rates are at the lowest level since the crisis.

Figure 2: Higher Treasury yields entirely due to real yields



Source : Bloomberg Finance LP, Deutsche Bank

Figure 3: Rise in trade-weighted US dollar accompanied by surge in real yields



Source : Bloomberg Finance LP, Deutsche Bank

This sharp rise in real yields has been associated with a run-up in the trade-weighted dollar. Dollar weakness, which resulted from the Fed's rapid volte face, rapidly reversed with the spike in real yields, and the dollar has now reached new multi-year highs on a broad trade-weighted basis (figure 3).

The real rate spike is simply the flip side of the collapse in breakevens. The risk with these dynamics is that they can easily become circular. Higher real yields strengthen the dollar and put downward pressure on commodity prices. Weaker commodities in turn further depress breakevens, increasing real yields. Softer commodity prices and inflation expectations ultimately weaken risk asset valuations more broadly, producing a damaging feedback loop that tightens financial conditions.

To counteract this dynamic, the Fed needs to use asset purchases to push real yields lower by targeting the term premium directly. While front-end yield curve control (YCC) has received significant attention from Fed officials recently, we think the best approach is traditional QE that is more focused at the long-end, as this is what is driving these adverse dynamics. With the Fed having completed $275bn of its $500bn of purchases already this week (Figure 4), a new announcement should be forthcoming next week. In turn, our base case is that the Fed will announce another $500 bn of Treasury purchases and $200 bn of MBS, focused particularly on the long-end, to promote market liquidity by further removing excess inventory from dealer balance sheets and compress the long-end term premium further. However, the size and composition of purchases will critically depend on how market conditions develop over the next week as the Fed completes its initial purchase commitment.

Figure 4: Fed purchases for the week of March 16 by sector

Fed Treasury Purchases week of March 16

	Bills 0 to 1	0 to 2.25	2.25 to 4.5	4.5 to 7	7 to 20	20 to 30	TIPS 1 to 7.5	TIPS 7.5 to 30	Total
Fri		25	17	11	6	9		7	75
Thu		25	17	11	6	9	7		75
Wed	5	15	4	8	3	5	5		45
Tues		15	10	5	3	4	3		40
Mon		10	8	9	5	5		3	40
Total	5	90	56	44	23	32	15	10	275
% of Total	1.8%	32.7%	20.4%	16.0%	8.4%	11.6%	5.5%	3.6%	

Source : FRB NY, Deutsche Bank

Into the unknown: Purchases of corporate and municipal debt?

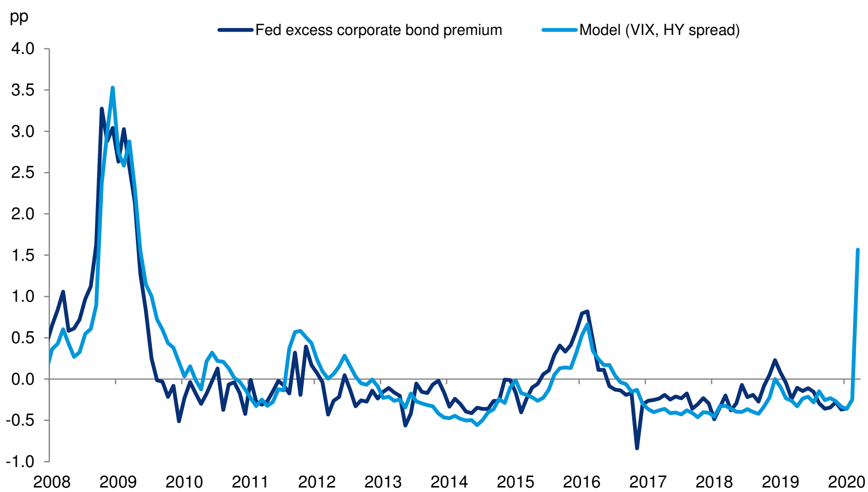
Two remaining areas of clogged transmission from monetary policy are corporate and municipal debt. While the Fed can legally purchase short-dated municipal debt, Congress would have to grant authority to purchase corporate bonds and longer duration municipal debt.[1]

While such a change likely seemed unthinkable in normal circumstances, unprecedented conditions could well call for extraordinary action on this front. In a recent op-ed, former Fed chairs Bernanke and Yellen said the Fed could make such a move to ensure that companies are able to maintain access to credit throughout this crisis, which can hopefully allow them to maintain key employee-employer relationships and avoid permanent damage to the economy. News reports have also noted that officials in congress have recently urged Chair Powell to help state and local governments that could be in dire straits.

The stress in corporate bond markets is evident, with spreads widening abruptly for both investment grade and high-yield. One measure that we prefer is the excess corporate bond risk premium, which is essentially the corporate bond spread adjusted for the expected default rate. Fed analysis has shown this to be a reliable indicator of recessions when it blows out. We have updated the Fed's measure given recent data on implied volatility and corporate bond spreads. Recent moves now far exceed the 2016 experience and are rapidly approaching the worst of the financial crisis (Figure 5).

1 It is unclear as of this writing whether the Fed could set up a CPFF-style facility to purchase corporate debt with Treasury backing or whether the difference in duration makes this impossible.

Figure 5: Fed's measure of excess corporate bond premium has widened aggressively



Source : Federal Reserve, Deutsche Bank

To ensure the adequate transmission of the Fed's actions to the economy, action on this front is likely to be needed. While a first step may be to re-establish the Term Auction Facility, which allowed for borrowing from the Fed at term for a broader array of counterparties against a broader array of collateral, direct intervention would likely prove more effective. Direct purchases inject a marginal buyer that is price-insensitive and does not require the intermediation of the banking sector, which may have competing considerations related to their regulatory obligations. Ultimately, we expect the Fed to show tremendous flexibility and to be willing and able to purchase corporate debt directly if Congress provides them that opportunity.

Related to municipal debt, the Fed has already taken some actions to address funding issues by expanding the list of securities accepted as collateral through the Money Market Mutual Fund Liquidity Facility to include munis. However, there has been, of late, discussion amongst some members of Congress that would expand the Fed’s ability to purchase muni debt with longer maturities than the current six-month limit. Services provided by state and local municipalities play an incredibly important role in combatting recessions. For example, unemployment insurance programs are provided by the states. Many states and localities are dependent on sales tax and other revenues that are proportional to economic activity. Thus, as economic activity slows, state and local budgets are put under increasing strain and lending to those municipalities looks to be an increasingly bad investment, just as those municipalities need money the most. Should the Fed be granted the authority to purchase muni debt as part of its QE powers, this could help to limit any unwanted rise in muni rates and allow for municipalities to have an easier time issuing debt, helping to maintain as much sense of normalcy in economic activity as possible in response to this unprecedented shock.

Conclusion

Recent market moves have run counter to the Fed's goals of easing financial conditions as the transmission of the Fed's extraordinary actions to the real economy has been clogged. The Fed has thus far shown an exceptional sense of urgency and flexibility in responding to this unprecedented shock. It is unlikely that revisions to – or expansions of – existing or past programs will be sufficient to promote accommodative financial conditions. As such, we should not discount the possibility that the Fed will receive authority to significantly expand the scope of what they can purchase, likely including corporate and municipal debt.

Appendix 1

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